RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

SINCE 1958 •

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26 LETTERS PER YEAR • $225 ANNUALLY

Jan. 13 DJIA 2226.07; PTI 2853; A-D Ratio -10.93
Jan. 20 DJIA 2235.36; PTI 2864; A-D Ratio -10.69
Current Dow Yield: 3.59; Dow P/E: 12.3
Dow Book Value: 1009; Dow 200-day MA: 2092
DowPow: 811
Percentage of undervalued blue-chips: 20%

Jan. 25, 1989 **LETTER 1009**

BETTING AGAINST HISTORY: Despite the crash of '87 the broad S&P 500 has now closed up seven years in a row, its longest string of up years ever. If 1989 sees the S&P up again, it will be a new record. Personally, I never like to bet on new stock market records. They're very rare.

A good deal of today's Treasury paper is now yielding 9% or better. At 9%, money doubles in just over eight years. The stock market, over a multi-year span, provides a return of roughly 9-10%. But the stock market doesn't guarantee a 9% return -- T–notes and bonds do.

RATES: Last week Europeans, in the face of a strong dollar, raised their rates 1/2% across the board. When the dollar turns strong, Europeans protect their own currencies by raising their rates. But when the dollar is weak, US rates rise in order to attract (or to hold) European money. Some cynics might even call it an incipient rate war.

THE PICTURE: "The same old faces deliver the same old forecasts," moans Lou Rukeyser in his weekly syndicated column. But, says Lou, if you know the answer to these three questions you'll know what to expect in 1989. All right, what are the questions? (1) Can George Bush come up with a credible budget program? (2) Will Fed Chairman Greenspan insist on a recession (translation: will Greenspan push interest rates too high)? (3) Will Congress wise up and halt their class-war rhetoric (translation: will Congress stop their ideological war against business and "the rich," a war which keeps the savings rate in the US low and hurts US competitiveness)?

There's no doubt but that these are critical questions, and, unfortunately, I doubt if any one on this green earth (if, indeed it still is green) has the answer to them. But the Dow Theory sees the whole situation in an entirely different light. The Dow Theory states that regardless of any questions that Louis Rukeyser or George Bush or Alan Greenspan or anybody else asks, the die is already cast. The die was cast back in August 1987 when the D-J Averages topped out and a primary bear market took hold.

Very few people really understand what the Dow Theory is saying. They simply don't understand the significance of the 1987 bull market top -- at which time the Dow recorded its high of 2722.42 and the Transportation Average recorded its high of 1101.16. Following those highs, the Averages rendered an October 15 Dow Theory bear market signal -- a few days later on October 19, the market fell apart in the worst crash in Wall Street annals.

Since then the Dow and the market have spent 15 months trying to regain part of what they lost in the first three months of the bear market (i.e., August to October). As of this writing, the Dow has just pushed a fraction of a percent above the important 2230 level.

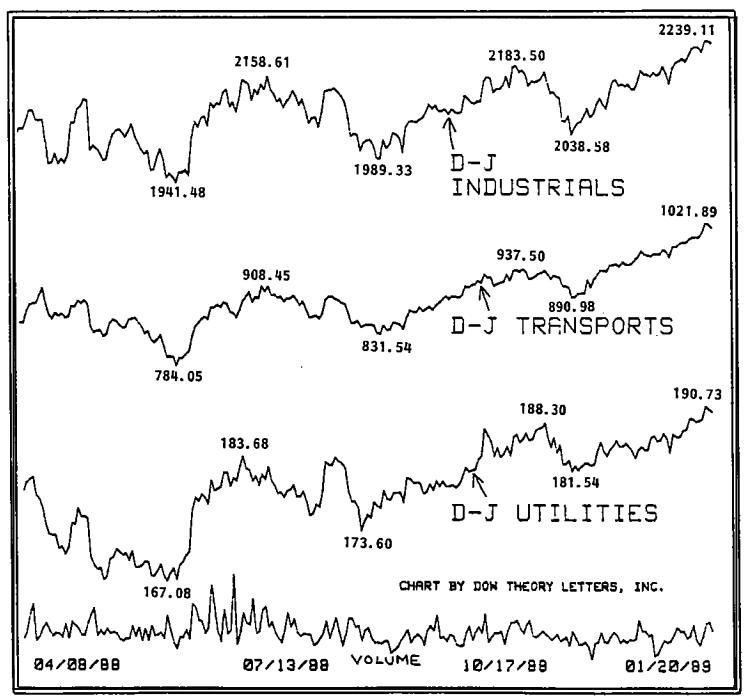
But the point I want to make is this: The Dow Theory is saying that it's a primary bear market. The Theory is saying that regardless of whether Lou Rukeyser's three questions are answered positively or negatively, regardless of which way the US trade balance goes, regardless of whether US business continues to boom, the **stock market in August 1987 discounted the best that could be seen ahead.** Yes, it's conceivable that the Averages could push up for another 15 months. Sure, business could stay rosy for another year. Agreed, George Bush could turn out to be a great president and make all the right moves. **But the market knows all this, it has digested all this, and it discounted all this at the '87 highs.**

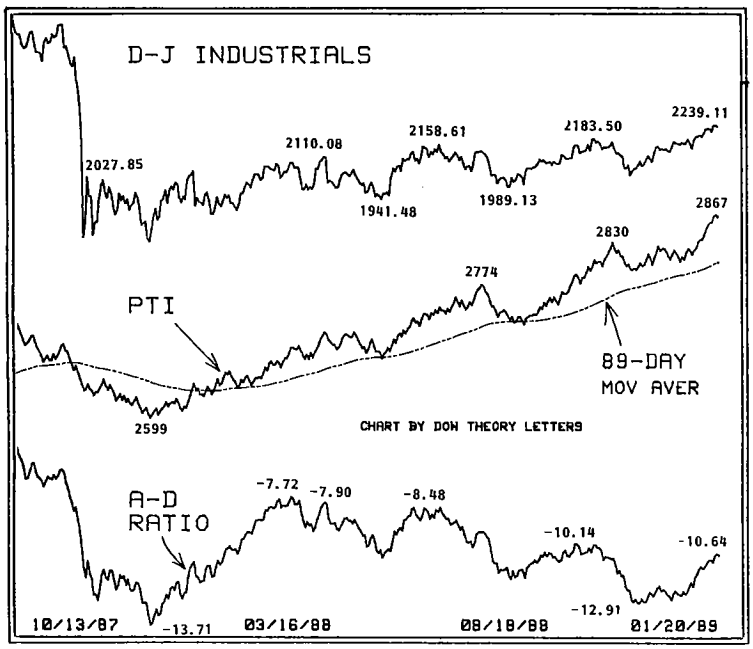
Thus, from a Dow Theory standpoint, it doesn't really matter what the Averages or the market do in this area, an area far below the '87 bull market peaks. As I said, the die has been cast, and for the last 15 months, what we've been seeing is a market that is licking its wounds, pushing up, recovering from the worst collapse in Wall Street history.

It's been a very unusual period for one reason. The reason is that the 1987 market top came so far ahead of actual economic trouble. In the past, analysts and observers were used to trouble following rather quickly after a major stock market top -- and certainly veteran observers have learned to expect trouble within six months of a stock market crash. But no two bear markets are alike. Each bull and bear market is accompanied by its own basket of tricks and foolers.

So far, the fooler in this bear market has been the time span between the market top and the actual onset of trouble. But then, I've stated many times that I expected this bear market to be extended, difficult and deceptive. And it has been.

PTI: My Primary Trend Index (see page 2 chart) has been rising all during 1988, and the PTI is still in the bullish mode (i.e., above its 89-day moving average). Thus, the PTI is telling us that the pressure in this market continues to be on the upside. Furthermore, based on past experience, I can say that there will be no major sell-off until the PTI reverses and forms a downtrend.





The power of the post-crash recovery is another story however. The power can best be gauged by another proprietary indicator -- DowPow, and there the picture is much less impressive (see later section on DowPow).

The Public and the Markets: The public was thoroughly traumatized by the '87 crash. Households sold $129 billion worth of stocks in 1987 and another $75 billion worth in '88. Equities as a percentage of financial assets held by households are now 20%, down from a high of 43% back in the halcyon days of 1966. Will the public come back? Frankly, I'm skeptical.

The reason I'm skeptical is based on one word -- INCOME. Consciously or unconsciously (in most cases consciously), today's consumers feel squeezed. And they're struggling to keep up their standards of living. One way the American family has attempted to keep up its standard of living is via the two-breadwinner family. Women, on a wide scale, have left home and gone to work (which may be a major factor in America's exploding crime rate).

The fact is that in order to halt the squeeze on their standards of living Americans need income, additional income, all the income they can scrape up. To increase their income Americans have been moonlighting, sending their wives to work or picking up extra green in the huge (untaxed) underground economy. As far as investments are concerned, Americans have also been moving into financial instruments -- instruments which produce real (after-tax, after-inflation) income.

Consider this: Two weeks ago at auction the 7-year Treasury notes went at a 9.3% yield. That equals a fat 2.59 times the current yield on the Dow. On a value comparison basis, either the T-notes are a bargain or the Dow is too expensive. An income-hungry public (increasingly sophisticated regarding interest rates) is opting for value. And the values today are in high-income financial instruments.

What's It Worth? Nobody is exactly sure how to value the Dow. One way is via dividend yield. At a major bear market bottom yields on the Dow usually hit 6% or better. If the Dow were to provide a 6% yield it would now have to sell at around 1335.

At the bottom of a bear market the Dow will generally sell below book value. Book value is now 1008, according to the latest *Barron's* figures.

Ben Graham, the legendary co-author of the *Intelligent Investor*, in his famous "central value" formula for detecting stock bargains, stated that one should take a stock's average earnings for the last 10 years and divide by twice the current yield on top-grade corporate bonds. Suppose we apply Graham's test to the Dow. But let's forget average earnings for the past 10 years -- let's just take earnings for the 12 months ending Sept. 30, 1987 (these are the latest earnings and the highest in history). Dividing those earnings (which were 181.04) by twice the yield on Barron's Highest-Grade corporate bonds (2 x 9.55%) gives us a "central value" of 947 for the Dow. Therefore, my guess is that Ben Graham would have given today's market a wide birth.

DOW 2230: That's the halfway level of the entire August-October bear market decline. I wrote about that level in two *Barron's* articles (both articles appeared in late-1987). The "halfway or 50% level" has subsequently been widely-advertised and widely-watched. Frankly, it always bothers me when any level or any concept receives too much publicity, and I hope this isn't the case with the 50% principle.

At any rate, the Dow has been flirting with the 2230 area for a number of days, and on January 18 the Dow, for the first time, closed above 2330. The close was only a fraction of a percent above the 2230 level, and we will have to see whether the Dow can move decisively above 2230 or whether the halfway recovery will prove to be too much of a barrier.

If the Dow can push decisively and powerfully above 2230 this would (technically) open the way for an eventual attack on the bull market high of 2722.42. On the other hand, if the Dow now sinks below 2230 and heads down, I would take this as an ominous sign.

A bit of history may be in order here. Following the 1966 bull market top of Dow 995.15, the Dow tumbled to 744. We then witnessed an extended trading-range period in which the Dow repeatedly attacked the 1000 level. After each attack the Dow fell back -- to 786 in '67, to 769 in '69, to 631 in '70, and to 577 at the final bear market low in 1974.

I have written before that this bear market could be fated to be as difficult and frustrating as the 1966-74 period (although obviously I hope not). At any rate, I believe it will be very important to see whether the Dow can move up impressively from the 2230 halfway level -- or whether 2230 marks the ceiling for the recovery. What the market does over the next month or so will be (in my opinion) critical for the development the bear market.

INVESTMENT POSITION: Over the last few years I have opted for high-grade bonds over stocks. Since the 1987 bear signal and certainly since the '87 crash I have stated that high-grade bonds (with emphasis on tax-free municipal bonds) represented a far greater VALUE than common stocks. The investment results of moving into bonds have been good.

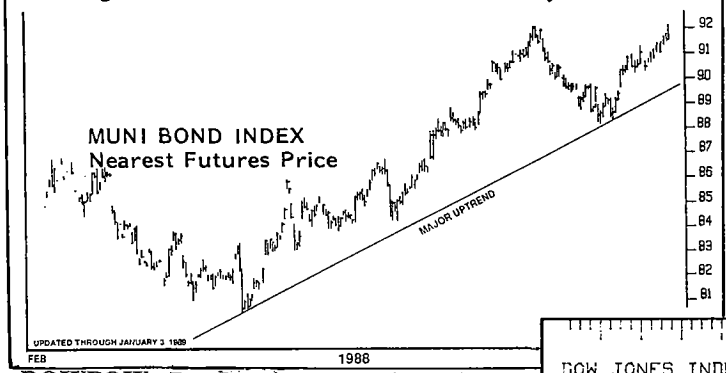
I gather from letters received here that a large percentage of my subscribers followed my advice, but I have no way of knowing exactly what your results have been. For my own part, I estimate that my portfolio of bonds is up roughly 15% since the crash lows. Add to that an average (tax-free) return of approximately 8%, and I show a 23% total return, one-third of which is tax-exempt. Considering the safety and quality of this position, I am more than satisfied.

I might as well reveal that one of the reasons I have been able to remain in this business for over 30 years is that I always attempt to "go with the value flow." And the best and safest flow may not always be common stocks. In the 1950s it was certainly common stocks. In the early 1970s it was cash, and from 1974 on it was stocks again. But in the late-'70s the place to be was gold, and we were there. In the early '80s it was again common stocks, although around 1985 I started singing the benefits of bonds (while presenting many studies of compounding). In mid-1987, my

position was to be "out of stocks," while continuing on our bond-buying program.

As this is written I am content with a bond and money instrument position. In the last Letter (pages 3 and 4) I presented Stanley Salvigsen's reasoning on bonds plus the thinking of the *Bank Credit Analyst*, both of whom I agree with.

So that's my current investment stance — basically, compounding the high real returns on bonds and money instruments and watching events in the stock market and the economy.



DOWPOW: DowPow is my proprietary index, and one that I have run for the past few years. Just what is DowPow? DowPow is the D-J Industrial Average adjusted for the daily action of the advances and declines on the NYSE.

I developed DowPow for a number of reasons. (1) One of the common complaints about the Dow is that it doesn't reflect the action of the whole market. To remedy that I developed an index which takes the Dow and adjusts it for the action of the rest of the market. (2) I wanted an index that (like my PTI) would tell me something that no other index would tell me and that nobody else could know. In other words, I wanted a market index that was not common knowledge. Since I have always followed the Dow and the A-D ratio closely, I decided that my ideal index might be a combination of both.

In studying the action of DowPow over the years I discovered a most fascinating phenomenon. DowPow tends to reflect (a) the really profitable market moves, (b) the really costly market moves and (c) the moves that do little or nothing. In other words, DowPow's action tends to show what actually happens to the average diversified stock portfolio.

My friend John Carder, using his voluminous market library (all on computer, of course) ran off this fine historical chart of DowPow and the Dow for me. The chart takes the two indicators back 19 years to 1970.

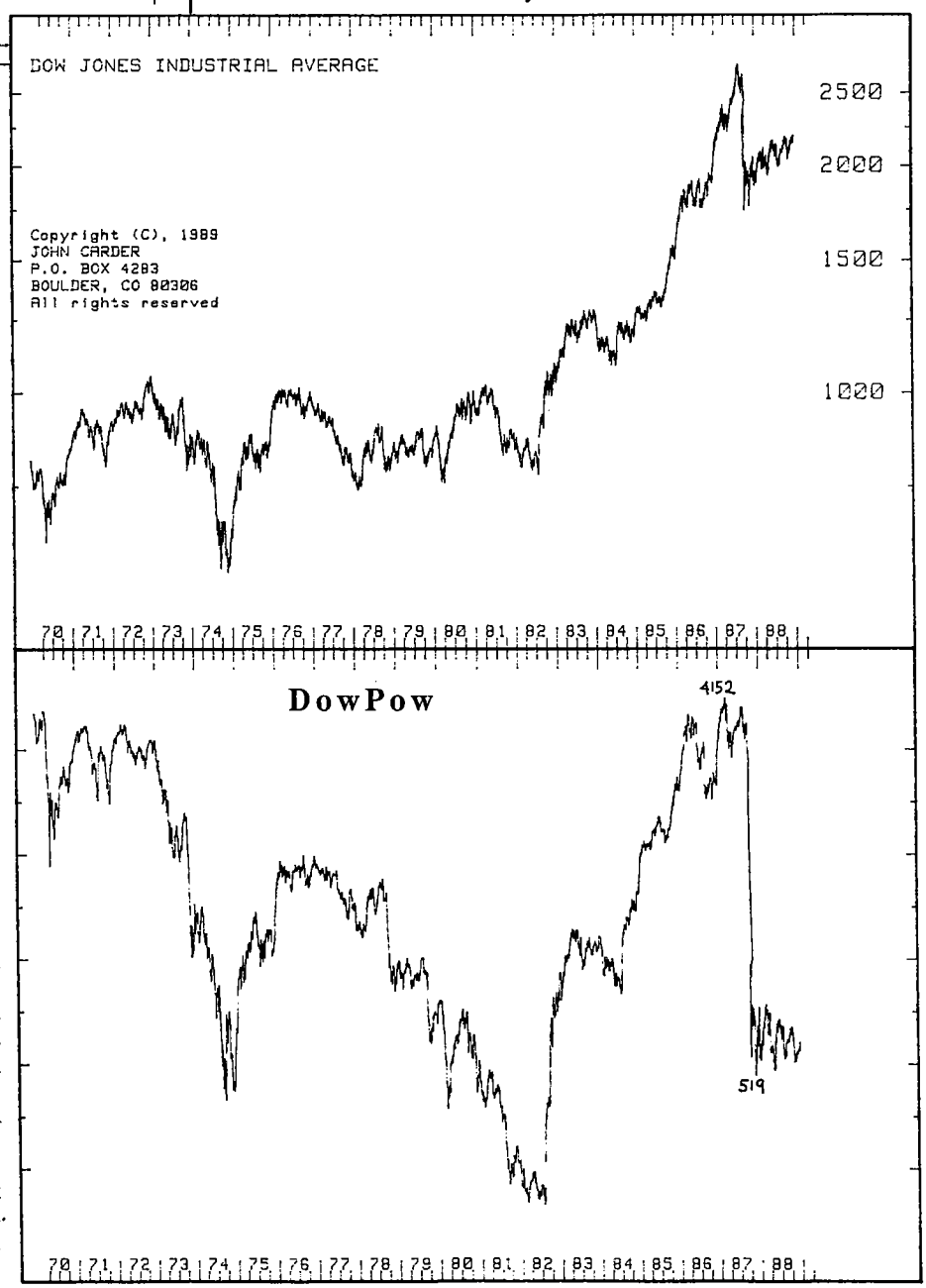
DowPow provides us with a different view of the market, one that we don't see when studying any of the major averages (such as the Dow, the Value Line or the S&P 500). For instance, note how precipitous the 1973-74 decline appears on DowPow. This was brought on by the massive bear market breadth collapse which occurred during those two years. Another shocker was the 1977-82 decline in DowPow. This five-year period shows up as a horror on DowPow while it appears as basically a sideways move on the Dow. However, those who were invested in stocks during 1977-82 know that DowPow was telling the true, rather torturous story.

It is surprising that DowPow was considerably lower at the 1982 low than it was at the 1974 bear market low. But it is also interesting to note that stock yields were actually higher in 1982 than in 1974, and therefore one can make the case that stocks were even greater bargains at the 1982 lows than they were at the '74 lows.

Subscribers who have followed DowPow only over the last year or so may not believe it, but DowPow can go up as well as down. This is seen in the upward explosions of 1975-76 and again in the rocket-rises of 1982-1984 and late-1984 to 1986.

The 1987 crash shows up dramatically on DowPow. But the period following the '87 crash low is one of the most fascinating in DowPow's history. For while the Dow has pushed up in a clear "rising wedge" pattern, DowPow has moved sideways while tracing out a distinct triangle pattern. Nothing like this divergence and these perfect patterns have appeared in the previous 19-year history of DowPow.

What does the post-crash action in DowPow tell us? As I interpret it, DowPow is saying that the post-crash rally was, for the average portfolio, not much of a money maker. In fact, in the face of the 15-month rise in the Dow, the move in DowPow has been a dud. The fact is that I can't find any other instances going back to 1970 where DowPow so stubbornly resisted a rise in the Dow.



I have pondered the meaning of the 1987-89 DowPow action as it pertains to the market and the future. Does it mean that when the Dow finally turns down the rest of the market will collapse? In other words, if DowPow has refused to rise in the face of a 15-month rally in the Dow, will it swoon when the Dow finally declines? Time alone will tell us.

This much seems clear: DowPow is capable of exploding skyward as it has done many times in the past. But DowPow hasn't rallied during 1987-89. That seems ominous on the face of it.

CHART BOOKS: I publish two chart books which I feel are indispensable for all serious investors and market students. The first is an album of the Averages, a chart page for each year, going back to 1885. Each yearly chart (plotted daily) traces the action of the D-J Industrials, Transports, Utilities and 20-Bonds plus daily volume. Important news events which affected the market are shown. The material shown in this album is available nowhere else.

The second album traces the Dow and the advance-decline ratio back to 1931 (daily), and again there is one page for each year.

The two albums present a huge amount of material for study and comparison, and hardly a week goes by that I don't refer to them in my own work. The chart pages are large, 11 x 17-inch, and are in a hard-cover, three-ring binder so that each new year's page can be added to the album. The price for the D-J Averages album is $135, price for the A-D ratio album is $95. PLEASE make all checks payable to Richard Russell. We pay the shipping (except on overseas delivery).

Important: For those who already own the albums, the new 1988 pages will be ready very shortly. Price is $3 per page -- please be sure to specify which years you need and for which album. Thank you.

ANNOUNCEMENT: A few months ago Julian Snyder, publisher of the well-known *International Moneyline* advisory letter called me from St. Moritz, Switzerland, where he lives. Julian told me that after many years of publishing his famous report, he finds it necessary to leave the business for health reasons. Julian has asked me to take over and fulfill the subscriptions of his 6,900 subscribers. I agreed to do this.

Therefore, as of February, I will be writing and mailing Dow Theory Letters to twice as many subscribers. Some of my own clients already subscribe to *International Moneyline*, and in that case (and in the interest of fairness), I will automatically extend your subscription to Dow Theory Letters for the period of time you have left on your *International Moneyline* subscription (in other words, you don't have to notify me, your subscription will be automatically extended).

NOTES & QUOTES: Maybe you didn't notice it, but crude oil (at well over $19 a barrel) is up a whopping 52% from its last October's lows. Also notable are the following facts: (1) Six leading OPEC members now hold 70% of the world's oil reserves; (2) the US now imports 50% of its oil, and (3) US oil production is now at a four-year low.

* *

Business Week, Jan. 16, offers these comments on the S&L takeovers: "A small group of sharp financial operators have gained control of $48 billion in assets of insolvent thrifts and have been handed huge tax write-offs by the federal government. They have also received what is, in effect, a 'call' on vast portfolios of Southwestern real estate whose prices are far more likely to go up than go down. This is the only way that federal authorities could see to deal with the 600 or so mortally ill S&Ls without adding to the visible budget deficit for 1989. But the result is an outrageous giveaway. The tax breaks are especially odious. Most end up in the hands of a small group of wealthy individuals who have been lured into the S&L mess by generous tax incentives that they did not even have to pay their accountant to find. The benefits were dangled before them by the federal government itself in a great year-end deal-making frenzy." Russell comment: Pretty, huh?

By the way, Congress has not yet backed the $18 billion in notes the FSLIC has issued to keep insolvent S&Ls afloat. Some angry Congressmen want to pass a resolution disavowing the notes. It's a mess and getting worse. Last week it was disclosed that S&Ls lost a huge $7 billion in deposits in November.

* *

On US debt in general, Dr. Henry Kaufman had this to say, "The dimensions of the mania are imposing. Decapitalization of US business, through the substitution of new debt for outstanding equity, is proceeding at a staggering pace. Over the past five years, the debt of the US nonfinancial corporations has gone up by an estimated $840 billion, and the equity position has contracted by nearly $300 billion. In the process, interest payments by US nonfinancial corporations have swollen to where they now absorb more than a quarter of internal cash flow. . . . It is important to bear in mind that this decapitalization has come into vogue under relatively benign circumstances. The weakened financial structure of so many corporations has not been tested during a business contraction when, unlike today, there will not be the swollen sales revenues and corporate income readily available to service a bloated mass of debt."

* *

In this century only one presidential candidate ever lost the election and came back to win the presidency. Who was he? He was Richard Nixon, of course (he lost in 1960 against John Kennedy). As a rule, however, losing a presidential election is a ticket to nowhere (as witness Mr. Dukakis).

* *

Which is the easternmost US state? Answer: Alaska. All right, which is the westernmost state: Answer: Alaska. Check it out.

* *

Elvis lives -- financially. The only entertainers (according to *Forbes*) who made more than the Presley estate (which brought in $15 million in 1988) were Michael Jackson, Madonna, Prince and George Michael.

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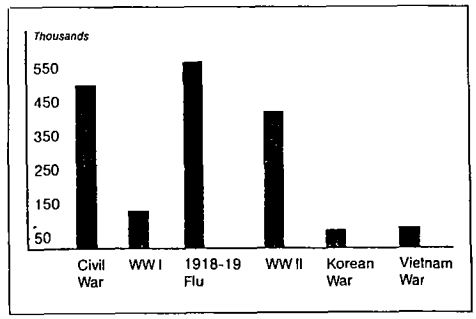
Want to move? Here are seven states that have no income tax -- Alaska, Florida, Nevada, S. Dakota, Texas, Wyoming, Washington. But alas, Washington's Gov. Gardner is now proposing a 3.9% income tax. And there are also other taxes. The five states with the highest tax burden per $1,000 of income are Wyoming, Alaska, NY, Hawaii, Wisconsin. The five states with the lowest tax burden per $1,000 income are New Hampshire, Missouri, Arkansas, Florida, Alabama. Gosh, Florida has both good weather and low taxes (the only problems in Florida are insects and drug dealers).

* *

Japan's annual share of US patents has grown from 4% to 15% over the past 15 years while America's has slid from 73% to 54%. The companies with the most US patents in 1987 (get this) were (1) Canon, (2) Hitachi, (3) Toshiba, and (4) General Electric. And, oh yes, the US share of world electronics has dropped from 50% to 40% in three years while Japan's rose from 21% to 27%.

* *

You think AIDS is a killer? *Smithsonian* (January) has an article on the great flu epidemic of 1918-19 in which more than 11 million people around the world died. Over half a million Americans died in that flu plague, more than America lost during the first World War (as this chart of Amrican deaths in various wars shows). By the way, the horrendous number of deaths during the Civil War were in large part due to infection. A wound during the Civil War (when there were no antibiotics) was very often followed by death by infection.



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If Russia wants to move past being a third world (economic) nation with a big military, she's got to have a convertible currency. The official Russian exchange rate for the ruble is $1.65. What's the ruble actually worth? Here's a hint -- the black market price for the ruble is 20 to 25 cents. Kamentasev, chairman of the state Foreign Economic Affairs Commission, recently denied the rumor of a 50% devaluation of the ruble. So the current story on rubles is that nobody knows what they're worth and nobody wants them anyway. . . . Meanwhile, Politburo member Alexander Yakovlev warned Party workers two weeks ago that *perestroika* has produced little in the way of real changes. Failure of reform could lead not simply to a return to the bad old ways but "a triumphant, aggressive and avenging conservatism." Translation: *perestroika* better work or Gorbachev could get his walking papers.

* *

Reagan never once submitted a balanced budget, but the actual results were worse than the unbalanced budgets that he submitted. Here's the record:

The Reagan Budgets

U.S. budget deficits, in billions

Year	Initial Reagan Budget	Actual	Difference
1982	-$45.0	-$127.9	$82.9 more
1983	-91.5	-207.8	116.3 more
1984	-188.8	-185.3	3.5 less
1985	-180.4	-212.3	31.9 more
1986	-180.0	-221.2	41.2 more
1987	-143.6	-150.4	6.8 more
1988	-107.8	-155.1	47.3 more
1989	-129.5	-161.5*	32.0 more
1990	-92.5	—— Not available ——	

*Estimate

And ta ta -- the final result, as included in this "hidden box" from the Jan. 10 *WSJ* (read it and weep):

Gross U.S. Debt to Exceed $3 Trillion in Fiscal 1990

By a WALL STREET JOURNAL *Staff Reporter*

WASHINGTON – The national debt will pass the $3 trillion mark in the coming fiscal year, the Reagan administration budget forecasts.

The administration says the gross federal debt will reach $3.107 trillion in the year starting Oct. 1, more than three times what it was when President Reagan took office. At the same time, that part of the debt held by the public will hit $2.285 trillion, the White House estimates; when Mr. Reagan came to town, it was $709.3 billion.

But good-natured president Reagan just doesn't get it. In his January 9 speech he stated, "Today, it is as if the world were born anew . . . The length, strength and resilience of this expansion is ample testimony to the wisdom of the policies that we have pursued." Russell comment: Periods of economic expansion and contraction come and go -- but a $2.6 trillion debt is forever (unfortunately).

* *

It's no Mickey Mouse outfit. Chairman Michael Eisner of Disney takes first prize for corporate compensation in 1988: $750,000 base salary, plus stock options and bonuses bringing his total pay to $40.2 million (and Eisner comes from a well-off family to boot). Second on the big-pay parade was Leno (call me Lee) Iacocca of Chrysler with a total compensation of $17.8 million. Third was Paul Freeman ("Mr. Sneakers") of Reebok with $15.4 million. Fourth was Phillip Rooney of Waste Management (who says there's no money in garbage?) with $14.2 million. Fifth was Richard Furland of Squibb (he makes the good kind of drugs) with just $13.8 million.

* *

Want to make it big in NY society? Easy, become super-rich and donate a few million to one of Gotham's major institutions such as the Public Library, the Metropolitan Opera, the Amer. Ballet Theatre, the Zoological Society (zoo to you), the Whitney, Guggenheim or MOMA. Ah, but the pinnacle is to be elected to the board of the Met (Metropolitan Museum of Art) and hobnob with the likes of the Dillons, Astors, Sulzbergers, Reeds. *New York Magazine* (Jan. 9) is damn sore about what's going on at the Met, however, and what's going on is a lot of glitzy parties with big money receptions and milion-dollar engagement parties. In fact the magazine entitles their expose, "Party Palace." The mag states that some of the old guard think the Met now represents "everything that is reprehensible and Philistine about the eighties." Sour grapes? Aw c'mon, it's fun and it makes great newspaper copy.

* *

They're taking a closer look at the S&L mess, and the word is that the situation will ultimately be seen as the biggest white-collar crime story in US history. Frederick Wolf, official of the General Accounting Office stated, "Fraud or insider abuse existed at each and every one of the failed thrifts (surveyed)." It seems clear that the FBI will be probing the S&L situation for years.

* *

The US water supply is turning bad in many areas. Proof: According to the International Bottled Water Assoc. consumption of bottled water has increased five-fold from 317 million gallons in 1977 to more than 1.5 billion gallons in 1987 and they're projecting increases of 10% to 15% a year.

* *

That George Burns -- he's 93-years-old, had triple bypass surgery in 1974, smokes 20 cigars a day, drinks (according to him) six martinis a day, makes $60,000 per performance and loves the ladies. He claims that his secret to longevity is a disciplined life. My guess is that the boy has good genes as well.

* *

Famous words for 1989 (so far): Rep. Jim Leach (R-Ia.) confronting Danny Wall, chairman of the FSLIC on the S&L deals, "The investors who bought the S&Ls have robbed you blind." . . . Joann Crespi, a lawyer opposing heavyweight champ Mike Tyson in a lawsuit. Crespi stated that after the deposition Tyson had asked her out. She stated "I told him, I'm the opposition," He replied, "So what, you're not doing anything."

* *

Somebody finally zeroed in on what I wrote at the beginning of Letter 1007. Here's how *Knight-Ridder News Service* (Jan. 12) headlined the massive US budget scam, the scam being that there's been no deficit reduction at all. The actual deficit is over $250 billion, and the phony "reduction" is due to the government's borrowing almost $100 billion from six different federal trusts.

Trust-fund surpluses seen hiding actual depth of budget deficits

Knight-Ridder News Service

WASHINGTON – Taking President Reagan's final budget at face value, it predicts a deficit in fiscal 1990 of $92.5 billion. But that's only a fraction of the actual depth of deficit financing, if the surpluses in various government trust funds are considered.

Those surpluses, which in 1990 are estimated to top $148 billion, are used in computing the bottom-line numbers in the budget – overall income versus overall outgo. And this,

'The President's assertion of a declining deficit comes almost exclusively from the growing Social Security surplus. If the veil of the Social Security surplus is removed, the actual deficit is more than $200 billion per year for the next five years.'

moved, the actual deficit is more than $200 billion per year for the next five years."

At a recent meeting with business economists, Robert J. Leonard, chief counsel of the House Ways and Means Committee, took up the same theme.

"If the trust funds were removed from the budget," he said, "then the real deficit would probably be $250 billion to $260 billion."

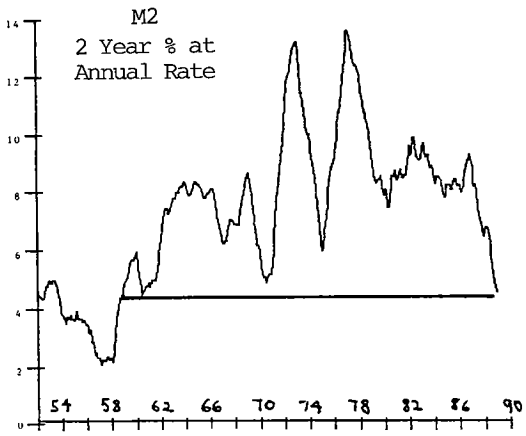
John H. Makin, director

MONEY: Alan Greenspan and the Fed are walking the tightrope. Inflation is pushing the 5% level (above that is unacceptable), and short-term interest rates are rising (Fed Funds, controlled by the Fed, are at the 9% plus level). The question on the Fed's mind: Is the economy strong enough to take higher rates? Furthermore, if rates rise from here, the dollar will almost surely push higher -- and a higher dollar makes US exports less competitive and imports cheaper.

At this point two phenomena are particularly worth noting. The first is that the interest rate curve is flat to inverted, meaning that the nearer-term rates are pushing above the longer-term rates. That's an indication of pressure on the money markets. In the past, an "inverted yield curve" has been a harbinger of recession. Now a recession is the last thing in the world the Fed wants. With every nook and cranny in America up to its ears in debt, a recession would be capable of "bringing down the house."

The second phenomenon is seen in this chart put out by Ed Hyman of *C.J. Lawrence*. The chart shows the growth of the the broad M2 money supply (based on the two-year rate-of-change). The growth rate has now dropped to its lowest level since 1958. Since there is a good correlation between the growth of the money supply and the growth of the economy, this chart has a lot of people wondering if there isn't a slowdown or a recession just around the corner.

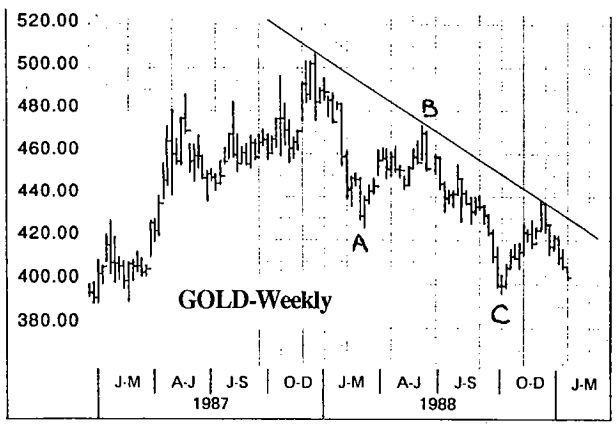
And it may be this chart that is fueling the longer–term bond market. A declining money supply is contra-inflationary, and if there's anything that long-term bonds like, it's a mildly deflationary background. We may have just that (which could also explain why the CRB Commodity Futures Index has been unable to push above 250 and hold there).



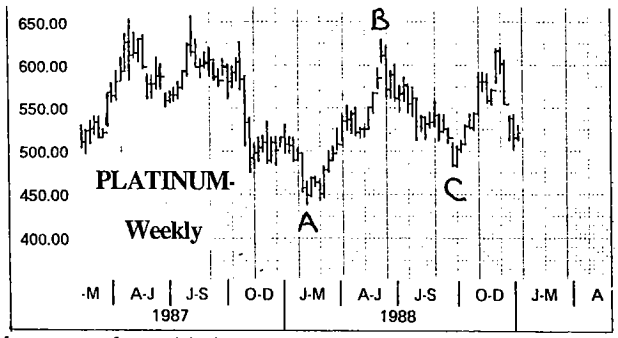
GOLD: My old friend Ian McAvity of *Deliberations* fame agrees with me on gold and paper production as he writes, "Given that some 70% of the OECD nations' central bank reserves are held in US dollars, and given that US federal debt has grown at a compounded 15% per annum rate between 1980 and 1987, nearly four times the rate of growth in gold production, I have long argued that any 'glut' people want to worry about is far worse in Washington 'paper' than in prospective gold mine output."

At any rate, the bearishness towards gold today is so thick you can cut it with the proverbial knife. Even gold-bugs are talking about 300-350 gold. On top of all the gold gloom, platinum was hit hard with the Ford publicity that they had found a substitute for platinum in emissions control (a claim that is yet to be proved).

But here's what I see. Gold has completed an A-B-C pattern down, and such patterns often (but not always) mark the completion of a down-move.



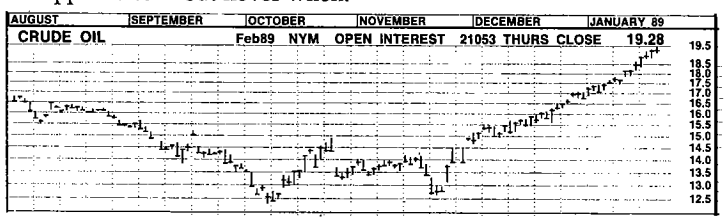
Platinum often leads gold, but should at least confirm a move in gold. But note this: Despite the adverse news, platinum at point C held above its first quarter low, and on the Ford news platinum even held above its September low at point C. On two counts, therefore, platinum has refused to confirm weakness in gold.



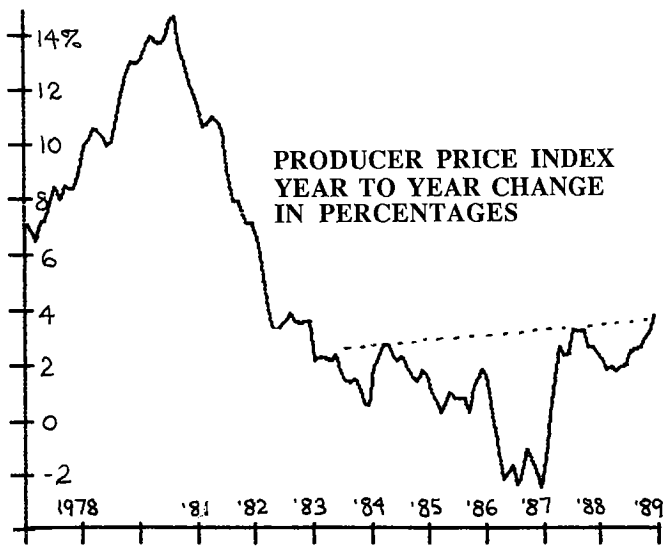
Furthermore, the gold shares have been very resistant to decline recently. And as I said, I correlate all this to the current black gloom regarding the metals. Charts courtesy of *Dunn & Hargitt* (32 N. 2d St., Lafayette, IN 47902).

At any rate, I continue to buy my fixed-dollar amount of gold coins each month (an "insurance" policy which I have been recommending to subscribers).

Note that the upward rush in the so-called "black gold" (crude oil) has not, so far, rubbed off on gold. Which brings up an old adage that I have learned to respect: "The market always does what it's supposed to -- but never when."



LATE NOTES: From a risk/reward standpoint, stocks don't stack up well here. Here's why: (1) The history of the stock market in post-election years is not a good one. (2) It is notable that 9 of the 11 recessions since 1929 have started within 14 months of a presidential election. (3) The sharply declining rate of M-2 money growth suggests an economic downturn is very possible this year. (4) Short-term interest rates (globally) are high and still rising. Last week European nations, led by West Germany, raised their bank rates again (in reaction to the stronger dollar). (5) Inflation may be about to surge, as this critically important chart (courtesy of Ed Hyman, *CJ Lawrence*) strongly suggests -- what we see here is a "head-and-shoulders bottom" in the producer price index.



In the meantime, as this is written the Dow is still bouncing about within less than a percentage point of the Dow 2230 halfway level. My PTI is still in its bullish phase, but the market is now quite heavily over-extended on the upside.

NEXT MAILING: Feb. 8